FEDERATION OF REGULATORY COUNSEL, INC.

CONSTITUTIONAL LIMITS ON THE STATE REGULATION OF CAPTIVE INSURERS

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Overview of the Use of Captives to Manage Risk

As an alternative to contracting with traditional insurers, a company may form a captive insurance company to insure the risks of the company and the company's affiliates.**1** A company may be attracted to forming a captive for a number of reasons. Funds set aside to self-insure risks may not be tax deductible as expenses, while insurance premiums paid to a captive are usually deductible in the current tax year.**2** Captives may also reduce the company's costs of insurance since the premiums paid to captives do not typically include a profit margin that traditional insurers include.**3** Captives may also provide a company with greater control of its risk-management strategy, including loss control, loss reporting, and safety procedures.**4** This may reduce the frequency and severity of insurance claims.**5**

The use of captives has grown substantially. Total captives in the U.S. increased approximately 15 percent from 2005 to 2006, from approximately 1,100 captives in 2005 to 1,250 captives in 2006. **6** Several states have also jumped on the captive bandwagon: over twenty states now have statutes that provide for the licensing and regulation of captives within their jurisdictions.**7** Offshore jurisdictions such as Bermuda and the Grand Cayman Islands also provide for the regulation of captives within their jurisdictions.**8**

State Regulation of Insurance

In the rush to form and operate captives, companies may not realize that the captives they form may be the subject of substantial and costly regulation in states where the captive operates, resulting in regulatory compliance costs that could offset any expected benefits. In general, under the McCarran-Ferguson Act, states have the power to regulate and tax insurance.**9** Such regulatory power, among other things, allows states to require insurers transacting insurance in the state to obtain a certificate of authority or a license.**10** States may also renew or revoke licenses, fix minimum capitalization and surplus requirements, and approve or disapprove rates.**11**

Under this authority, the insurance laws of most states prohibit the transaction of insurance unless the insurer possesses a certificate of authority. The process of obtaining a certificate can be a very costly and burdensome process. However, unless a specific statutory exemption applies, a company may have no alternative. This situation is likely very common: although Vermont is a leading domicile for the formation of captives, it is unlikely that those captives are only operating or insuring risks within Vermont.

Constitutional Limits on State Regulatory Power

The U.S. Constitution may shield captives from states' regulatory authority. The Due Process Clause provides that no state shall "deprive any person of life, liberty, or property, without due process of law."**12** A state

may regulate or tax an out-of-state transaction only when the state has a "substantial connection" with that transaction.[13] A substantial connection exists if two requirements are met: (1) there are "minimum contacts" between the state and the person, property, or transaction the state seeks to tax; and (2) there is a "rational relationship" between the income attributed to the state for tax purposes and the intrastate values of the enterprise.[14]

The Due Process Clause is concerned with fundamental fairness.[15] Applied to captives, courts would consider whether the captive's connections with a state are sufficiently substantial to provide the captive with sufficient "notice" or "fair warning" that the captive should be subject to the state's jurisdiction.[16] Where the transaction of insurance has no conceivable connection with a state whatsoever, the Due Process Clause would prohibit state regulation since the captive would have no "fair warning" that it would be subject to regulation.

State Board of Insurance v. Todd Shipyards Corp. is the leading case that establishes limits on states' power to regulate insurers with insufficient connections.[17] In that case, the insured was a New York corporation doing business in Texas.[18] The insurer was not licensed to do business in Texas.[19] The insurer also had no office or place of business in the state.[20] Further, it did not solicit business in the state, had no agents in the state, and did not even investigate claims in the state.[21] Lastly, the contract was negotiated and paid for out of state.[22] The court held that the state's taxes and regulations violated the Due Process Clause because the only connection between Texas and the insurance transactions was that the insured property was located in the state.[23] The court's holding suggests that a captive not licensed in a state may be exempt from the regulation and taxation by the state when the only connection the captive has with the state is that it insures property there.

While *Todd Shipyards* has not been overturned, in the years since *Todd Shipyards* was decided, the courts have limited the decision to its specific facts. For example, in *Associated Electric & Gas Insurance Services, Ltd. v. Clark*, the Supreme Court of Rhode Island held that the state could lawfully tax an out-of-state insurer not licensed to conduct insurance business in the state.[24] The insurer utilized the mail to negotiate business with four major gas utilities domiciled within the state.[25] Additionally, the insurer collected millions of dollars in premiums from the four utilities.[26] The court held that the insurer had purposefully availed itself of the benefits of the state's economic market, and therefore, the tax did not violate the Due Process Clause.[27]

Similarly, in *Risk Managers International, Inc. v. Texas*, the Court of Appeals of Texas held that Texas' injunction preventing an insurer from conducting business in the state was lawful.[28] In that case, the insurer was a British West Indies corporation not licensed to conduct insurance business within the state.[29] The insured was domiciled in Texas and received premium payments in the state.[30] Further, the insurer communicated with the insured by facsimile, mail, and telephone.[31] The court held that the state could regulate the insurer when, among other things, it negotiated with an insured who was domiciled in the state.[32]

Although narrowed, *Todd Shipyards* has continued to serve as a shield from state regulation when nearly identical facts have arisen. For example, the court in *Dow Chemical Co. v. Rylander* held that a state tax on insurance transactions occurring out of state violated the Due Process Clause.[33] In *Dow Chemical*, the insurers were not licensed to conduct insurance business in Texas.[34] In addition, the insurance agreements were contracted for and accepted out of state.[35] Further, all the premiums were paid out of state.[36] The insurers had no offices or agents in the state and did not solicit business within the state.[37] Notably, the insured was a Delaware corporation headquartered in Michigan.[38] As such, the court found that the state's tax violated the Due Process Clause because the only connection the state had was that the insured property was located in the state.[39]

The synthesis of the law is that when the only connection between the state and insurance transaction is that the insured property is located in the state, courts have found that the Due Process Clause precludes state

regulation.**40** However, courts are less likely to apply a Due Process shield if there are any additional contacts, including providing insurance to a resident of a state, collecting premiums from within the state, or using the mail within the state. The findings in those cases suggest that any of the captive's activities beyond insuring property in the state may subject the captive's transactions to the state's regulations and taxes.

Conclusion

In the rush to obtain the benefits associated with formation and operation of captives, companies may not realize that the captives may be subject to the taxation and regulation by the states in which the captives operate. Companies that are planning to form a captive should consult not only with tax and business counsel, but also with counsel familiar with the insurance regulatory framework in the states in which the company has risks that will be insured by the captive. In some cases, specific statutory exemptions may be available that permit a captive to transact insurance without a certificate of authority.

However, in cases where no specific exemptions are available and where the only relationship with the state is the existence of the insured property, a Due Process argument may be a company's only option for resisting state regulation. Although the U.S. Constitution may limit some of the states' powers to tax and regulate the activities of captive insurance companies operating within their borders, a company should consider relying on those limits only in narrow circumstances.

Endnotes

1. *See, e.g.*, MARY C. VEED, *The Re-engineering of the U.S. Commercial Insurance Market: Open Doors or Open Season?,* in 789 PRACTICING LAW INSTITUTE, COMMERCIAL LAW AND PRACTICE COURSE HANDBOOK SERIES 129, 151 (1999).

2. Anne M. Unger, *Captive Insurance Can Help Manage Risk*, MidMarket Advantage 7 (2007).

3. *Id*. at 6.

4. *Id*.

5. *Id*.

6. Dennis P. Harwick, The US: A Growing Acceptance of Captives (2007) http://www.uscaptivemagazine.com/07/article1.html.

7. *Id*. (listing the following jurisdictions: Arizona, Arkansas, Colorado, Delaware, District of Columbia, Georgia, Hawaii, Illinois, Kansas, Kentucky, Maine, Montana, Nevada, New York, Oklahoma, Rhode Island, South Carolina, South Dakota, Tennessee, Utah, and Vermont).

8. VEED, *supra* note 1, at 151-52.

9. McCarran-Ferguson Act, 15 U.S.C. § 1011.

10. *See, e.g.,* WASH. REV. CODE ANN. § 48.05.030(1)(LexisNexis 2007).

11. *See* LEER. RUSS & THOMAS F. SEGALLA, COUCH ON INSURANCE § 39.2 (ED ED. 2005).

12. U.S. CONST. amend. XIV § 1.

13. *See, e.g., Quill Corp. v. North Dakota*, 504 U.S. 298, 306 (1992).

14. *See, e.g., id.*

15. *See, e.g., id.* at 312.

16. *See, e.g., id.*

17. *See Todd Shipyards*, 370 U.S. at 453-55

18. *Id.* at 455.

19. *Id.* at 454-55.

20. *Id.* at 455.

21. *Id.*

22. *Id.* at 454.

23. *See id.* at 454-55.

24. *See Assoc. Elec. & Gas Ins., Ltd. v. Clark*, 676 A2d 1357, 1362 (R.I. 1996).

25. *See id.*

26. *See id.*

27. *See id.*

28. *Risk Managers Int'l, Inc. v. Texas*, 858 S.W.2d 567, 568 (Tex. App. 1993).

29. *Id.*

30. *Id.* at 571.

31. *Id.* at 569.

32. *Id.* at 571.

33. *See Dow Chem. Co. v. Rylander*, 38 S.W.3d 741, 746 (Tex. App. 2001)

34. *Id.* at 743.

35. *Id.* at 746.

36. *Id.*

37. *Id.*

38. *Id*. at 742-43.

39. *See id*. at 746.

40. *See, e.g., Quill* at 306.